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No. 91-1135

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1992

NEWARK MORNING LEDGER CO.,
as successor to The Herald Company,

Petitioner,

—v.—

UNITED STATES OF AMERICA,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE THIRD CIRCUIT

REPLY BRIEF OF PETITIONER NEWARK MORNING LEDGER CO.

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ARGUMENT

The government concedes, as it must, that in order to achieve the proper matching of income and expenses in a particular taxable period, all wasting assets with determinable lives, including intangible assets, are depreciable under section 167 of the Internal Revenue Code ("section 167") and Treasury Regulation 1.167(a)-3 ("regulation 1.167(a)-3"). (Gov't Br. at 11-12.) The government also concedes that goodwill is cast as nondepreciable under regulation 1.167(a)-3 only because "goodwill has no determinate useful life of specific duration." (*Id.* at 13.) Because Ledger proved that the 460,000 specific subscriber relationships purchased as part of the acquisition of the Booth Newspapers have limited useful lives and ascertainable

values, the government's concessions should establish that Ledger is entitled to a depreciation deduction for these assets.

The government nevertheless argues that Ledger is not entitled to depreciate its subscriber relationships because they are the "core" of "goodwill." The government reaches this inconsistent result by arguing that (i) *all* customer relationships (unless embodied in fixed-term contracts) are nondepreciable goodwill, notwithstanding undisturbed findings of fact that the subscriber relationships here lack goodwill's hallmark characteristic of an indeterminable useful life (Gov't Br. at 13-21); and (ii) the customer relationships in *every* business are, like goodwill, a single, self-regenerating asset with an unlimited useful life and a fluctuating value, notwithstanding undisturbed findings of fact to the contrary with respect to the subscriber relationships here. (*Id.* at 21-25.) The first argument rests on the erroneous proposition that an analytically ungrounded *per se* rule—incorrectly equating all patronage with "goodwill"—may override the unequivocal mandate of section 167 that all assets proven to waste *shall* be depreciable. The second argument turns on a mischaracterization of the assets at issue, is flatly contradicted by the record in this case and is nothing less than an attempt—never expressly acknowledged by the government—to resurrect the long discredited and interred *per se* "mass asset" rule.

I.

LEDGER'S WASTING SUBSCRIBER RELATIONSHIPS ARE DEPRECIABLE, AND THE GOVERNMENT OFFERS NO RATIONAL JUSTIFICATION FOR ITS CONTRARY POSITION

A. The Government Concedes That The Only Reason Goodwill Is Nondepreciable Under Regulation 1.167 (a)-3 Is That It Is An Asset With An Indeterminable Life

The government concedes that the defining characteristic of goodwill under the income tax laws is its indeterminable life.

(Gov't Br. at 9, 13-14.) The government also acknowledges that regulation 1.167(a)-3 casts goodwill as nondepreciable precisely because it possesses this defining characteristic. (*Id.* at 13-16.) Indeed, any other reading of the regulation would conflict impermissibly with the plain words of the governing statute—that all wasting assets *shall* be depreciable—and the fundamental matching principles which underlie the entire Internal Revenue Code. In spite of the fact that Ledger's subscriber relationships do not possess goodwill's signature characteristic but instead, as found by the district court, have determinable lives—a finding not disturbed by the Third Circuit on appeal—the government clings to the notion that Ledger's assets are nondepreciable goodwill because they represent patronage, the purported "core" of goodwill. (Gov't Br. at 16-19.)

At the heart of the government's position is the assumption that, based on a myriad of inconsistent, vague descriptions of goodwill, the limitation on depreciating goodwill contained in regulation 1.167(a)-3 is an historically-sanctioned, freestanding prohibition. This assumption is at odds with the government's contrary concession—that the only reason goodwill is cast as nondepreciable under the regulation is that it has an indefinite life; and it is simply wrong. In fact, as Ledger demonstrated in its opening brief, the history of regulation 1.167(a)-3 clearly demonstrates that goodwill was cited as an example of a nondepreciable asset *only* because it has an indeterminable life. (Pet. Br. at 21-24.)[1] Moreover, in contrast with the government's assertion that "the basic features of goodwill

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1 The government is incorrect that the predecessor regulation to regulation 1.167(a)-3 was first promulgated in 1927. (Gov't Br. at 13.) As Ledger previously demonstrated, goodwill was first cast as nondepreciable under the Treasury regulations in 1919 because it was an *example* of an asset that has no determinable life; the regulation was amended to delete this example that same year when the enactment of the Prohibition amendment made it possible for taxpayers to prove that their goodwill had a determinable life; and goodwill was again cast as nondepreciable under the Treasury regulations in 1927 when the Eighth Circuit held that, because goodwill was not subject to wear and tear or exhaustion on the date of purchase, no obsolescence deduction for goodwill was permitted under the predecessor to section 167. (Pet. Br. at 21-24.)

. . . were well known before the regulation was first published" (Gov't Br. at 16), the concept of goodwill has always evaded precise definition, and its contours continue to confound scholars even today. (*See* Pet. Br. at 25-27.) As this Court stated in *Metropolitan Bank* v. *St. Louis Dispatch Co.*, 149 U.S. 436 (1893):

> Undoubtedly, good will is in many cases a valuable thing, although there is *difficulty in deciding accurately what is included under the term.*

Id. at 446 (emphasis added).

The government's attempt to portray goodwill as a sacrosanct concept capable of overriding the express mandate of section 167 is unfounded.

B. The Government's Concession That Fixed-Term Customer Relationships Are Not Goodwill Demonstrates The Fundamental Illogic Of Its Position That Ledger's Subscriber Relationships Are Goodwill

The government maintains that customer relationships embodied in written contracts with "specified" terms (Gov't Br. at 43) are depreciable assets, but that Ledger's wasting subscriber relationships are nondepreciable goodwill. The government's unfounded distinction between fixed-term and at-will customer relationships is completely at odds with regulation 1.167(a)-3. That regulation expressly permits the depreciation of all intangible assets where, as here, the taxpayer demonstrates "by experience or other factors" that the assets have determinable lives "which can be estimated with reasonable accuracy." The government's position, therefore, amounts to a naked, impermissible attempt to rewrite regulation 1.167(a)-3—a regulation the government maintains has the "effect of law." (*Id.* at 16.)[2]

2 Contrary to the government's position here, this Court has held that there is no difference between fixed-term contracts and at-will contracts under the Internal Revenue Code because such a distinction would impermissibly exalt form over substance. *See United States* v. *Swank*, 451 U.S. 571 (1981). (*See also* Pet. Br. at 39-42.) Indeed, if the depreciation of customer relationships under section 167 were to turn on whether they are characterized as "contractual" or "noncontractual," as the government urges, resort to the laws of 50 states would be necessary, with its attendant potential for the differential treatment of identical assets. An asset's characterization under state law is not determinative for federal tax purposes; rather, the economic substance of the underlying transaction is controlling. *See Morgan* v. *Commissioner*, 309 U.S. 78, 80-81 (1940) (federal law determines what interests or rights shall be taxed "no matter what name is given to the interest or right by state law"). In any event, under Michigan state law, which would govern the Michigan-based subscriber relationships at issue here, the government's characterization of Ledger's subscriber relationships as "noncontractual" (Gov't Br. at 7 n.6, 9-10) is incorrect. (Pet. Br. at 39 n.44.)

The government's characterization of Ledger's subscriber relationships as goodwill is based on the fact that they represent patronage. However, although "goodwill"—whatever it is—may be *related* to patronage, the government concedes that patronage is *not* synonymous with goodwill under the income tax laws. Indeed, the government admits that customer relationships embodied in fixed-term contracts—pure patronage—are not goodwill for income tax purposes "because the contract itself specifies that the relationship will last for only a fixed term . . . ." (*Id.* at 43.) Moreover, many businesses with continued customer patronage have been found to have *no* goodwill for income tax purposes. (Pet. Br. at 26.)

In sum, the government concedes that customer relationships—patronage—are depreciable if they have determinable lives. Ledger proved by "experience or other factors," and the district court expressly found, that Ledger's subscriber relationships have determinable lives—a finding that the Third Circuit did not disturb on appeal. Accordingly, the government's contention that Ledger's subscriber relationships are not depreciable because they represent patronage is inconsistent with its own regulation and concessions.

C. The Government's Descriptive Approach To Goodwill Yields Inconsistent Results For Similarly Situated Taxpayers

It is not surprising that the government's approach—grounded on a variety of vague and sometimes conflicting

descriptions of goodwill—yields unjustifiable and inconsistent results, for it lacks any analytical rigor for income tax purposes. It provides no useful guidance or workable standards for administering the tax laws. (Pet. Br. at 32-45.) Thus, while the government simply assumes that its various "definitions" of goodwill are clear and interchangeable, they are not.[3]

For example, under one of the government's "definitions," goodwill is "that element of value which inheres in the fixed and favorable consideration of customers . . ." (Gov't Br. at 17)—a description that would include fixed-term customer contracts, which the government concedes are not goodwill. Another "definition" describes goodwill as "the advantage that the proprietor of an existing business enjoys resulting from the probabilities that old customers will continue their patronage" (*id.* at 18)—a description that suggests that goodwill is not the *customers themselves*, but rather something that *attracts* the customers, including such concededly depreciable assets as a patent or an attractive sign. In fact, the inherent problems with employing the government's descriptive approach to depreciation have already become manifest. Although the government asserts that covenants not to compete are paradigms of depreciable assets because they have specified terms (Gov't Br. at 43), the IRS has recently taken the contrary position that these assets may well fall within the core of nondepreciable goodwill. *See* Internal Revenue Service Industry Specialization Program Coordinated Issue Papers, *All Industries, Covenants Not To Compete*, (May 7, 1992), *reprinted in* 95 Daily Tax Rep. (BNA Special Supp.) at S-5 (May 15, 1992).

D. The Method By Which A Taxpayer Values A Wasting Asset Does Not Render The Asset Goodwill

The government also suggests that Ledger's wasting assets are rendered nondepreciable goodwill by virtue of the income method Ledger employed to value the assets. (Gov't Br. at 19-

3 Several amici curiae have pointed out that the government's various "definitions" of goodwill provide them with insufficient guidance as to what types of intangible assets are depreciable. (*See, e.g.*, Black & Decker Corp. Br. at 26-27; Investment Counsel Association of America, Inc. Br. at 8-11.)

21.)[4] This argument, too, is misplaced, for the method by which an asset is valued can never determine whether it is *subject* to a depreciation allowance. (*See* Pet. Br. at 48-49.)[5] Moreover, the government's argument incorrectly assumes that Ledger's subscriber relationships are indistinguishable from all other customer relationships; the government ignores that indefiniteness and uncertainty are the hallmarks of goodwill. As

4 The government alludes to the fact that, in calculating the $68 million fair market value of the subscriber relationships, Ledger did not deduct costs to produce or to distribute the newspaper. (Gov't Br. at 4 n.3, 6 n.5.) The district court correctly found that because production and distribution costs would necessarily be incurred whether the newspapers were free distribution or subscription newspapers, such costs were not attributable to the subscriber relationships. (Pet. App. at 46a.)

Other than questioning these two costs, the government does not take issue with the *amount* Ledger allocated to the subscriber relationships, although it states that the government's alternative valuation method valued the subscriber relationships at $3 million. (Gov't Br. at 6 n.5.) Nevertheless, the factfinder determined that the government's valuation method was entitled to no weight because, among other things, the government's experts valued the *wrong asset* and incorrectly attributed the greatest value to the least valuable subscribers and the least value to the most valuable subscribers. (Pet. Br. at 46-47.)

5 The government also implies that the $68 million Ledger seeks to depreciate—and "shelter from tax"—is simply the future income generated by its subscriber relationships. (Gov't Br. at 20.) This assertion is without merit. The record established that the future income stream of the subscriber relationships is over $384 million (Report of Valuation Engineering Associates, Pl. Ex. No. 1, admitted Tr. at 446; 3rd Cir. J.A. at 909-1009)—income on which Ledger, in fact, pays income tax. In contrast, the income method by which intangible assets are normally valued, and the valuation method Ledger used in this case, assesses the fair market value of assets *on the date of acquisition*. The income method simply reflects the amount a willing buyer would pay a willing seller for an intangible asset at a specific time by calculating the *present value* of the income that the buyer can anticipate receiving from the asset over the determinable life of the asset. In this case, using the income method, the value of the subscriber relationships upon acquisition of the Booth Newspapers was calculated to be $68 million. Thus, Ledger simply seeks to depreciate the value of the assets over their determined lives. If Ledger had acquired a patent—an indisputably depreciable intangible asset—as part of the Booth transaction, it would pay income tax on the revenues the patent generates over time *and* depreciate the present value of those revenues at the time of acquisition—the "fair market value" of the patent—over the determinable life of the patent.

expressly allowed by regulation 1.167(a)-3, Ledger proved—and the district court found—that there is no uncertainty associated with the subscriber relationships at issue in this case. Unlike the government's hypothetical grocery store customers, Ledger's subscribers are not "ordinary customers" (Gov't Br. at 3)—customers who must make daily affirmative decisions to continue patronizing the business—and the value of the subscriber relationships "does not depend upon a vague hope" that they will continue to purchase newspapers. *See Citizens & Southern Corp.* v. *Commissioner*, 91 T.C. 463, 499 (1988), *aff'd*, 919 F.2d 1492 (11th Cir. 1990); *Colorado National Bankshares, Inc.* v. *Commissioner*, 60 T.C.M. (CCH) 771, 789 (1990), *appeal docketed*, No. 91-9019 (10th Cir. Oct. 3, 1991). Rather, in contrast to anonymous grocery store customers who have unpredictable buying habits and indeterminable lives, the value of Ledger's subscriber relationships here is ascertainable based on the quantifiable, regular purchases (at fixed prices) the subscribers will make over the proven future periods the relationship will last. (*See also infra* at 11-12, discussing the difference between Ledger's 460,000 individual subscriber relationships and a mass customer base.)[6]

6 The government's argument that experts can establish a predictable life and value for any customer relationship is premised on an unfounded distrust of factfinders. (Gov't Br. at 21, 24.) The government's cynicism concerning expert testimony is belied by the facts in this case. Ledger's experts were unable to make such determinations concerning the lives or values of the newspapers' newsstand customer relationships or advertising customer relationships. (Pet. Br. at 31 n.33.) Similarly, amicus curiae Coopers and Lybrand, a national accounting and consulting firm that is regularly engaged as an expert to ascertain assets' lives and values, has stated that it is *not* capable of predicting a life and value for all customer relationships. (Coopers & Lybrand Br. at 11.)

The government's argument also questions the appropriateness of one of the most fundamental tenets of American jurisprudence—the exclusive province of factfinders to assess the credibility of witnesses, to weigh the evidence presented and to render factual findings. These firmly-rooted principles have always been given full force in tax cases. Indeed, in order to implement the fundamental matching principles of the Internal Revenue Code, factual inquiries, and not *per se* rules, are essential. *See Tank Truck Rentals, Inc.* v. *Commissioner*, 356 U.S. 30, 35 (1958) (fact-based inquiries are necessary "to accommodate . . . the congressional intent to tax only net income").

E. The Government's *Per Se* Rule Equating Patronage With Goodwill Conflicts With Settled Precedent

The government maintains that taxpayers have been permitted to depreciate customer-based intangible assets in only a minority of cases, and that the Third Circuit's decision here—adopting the government's unanalytical descriptive approach to depreciation—comports with "settled precedent." (Gov't Br. at 32-43.) However, since at least the Fifth Circuit's decision in *Houston Chronicle Publishing Co.* v. *United States*, 481 F.2d 1240 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974), the trend of the law has been that the depreciation of customer-based intangibles turns on factual inquiries and not *per se* rules. (Pet. Br. at 32-44.) The Third Circuit's decision is thus an aberration. In fact, after the *Houston Chronicle* decision, even the IRS ruled that it would abandon the *per se* approach the government now urges this Court to adopt. *See* Rev. Rul. 74-456, 1974-2 C.B. 65.

Even the few post-*Houston Chronicle* cases cited by the government do not support its current position that all patronage-related assets are *per se* nondepreciable goodwill. Instead, where depreciation deductions were denied, it was because the taxpayers failed to satisfy the factfinder that the assets at issue had limited lives and/or ascertainable values.[7] Indeed, in one case cited by the government, the court correctly held that a depreciation deduction in some amount *must* be allowed where, as here, the taxpayer had proven that the assets had limited lives and ascertainable values. *See Computing & Software, Inc.* v. *Commissioner*, 64 T.C. 223, 235 (1975), *acq.*, 65 T.C. 1153 (1976).

The government's discussion of *Houston Chronicle* also highlights the fundamental flaws in the government's argu-

7 Although the two-part depreciation test adopted by the Fifth Circuit in *Houston Chronicle* speaks in terms of "value separate and distinct from goodwill," in fact, consistent with section 167 and regulation 1.167(a)-3, *Houston Chronicle* held, as courts repeatedly have since held, that an asset is "separate and distinct" from goodwill if it is proven to lack goodwill's defining characteristics—an unlimited life and an unascertainable value. 481 F.2d at 1249. (*See also* Pet. Br. at 33-38.)

ment. (Gov't Br. at 35-37.) First, the government erroneously suggests that the only reason the taxpayer in *Houston Chronicle* was able to prove that the value of its customer-based asset was "separate and distinct from goodwill" was because, as the asset was not acquired as part of an ongoing business, no goodwill was acquired in the transaction. (Gov't Br. at 36-37.) Although the taxpayer in *Houston Chronicle* did not acquire an ongoing business, it did, in fact, acquire goodwill in the transaction and thus, like Ledger here, allocated separate values to customer-based intangibles and goodwill and proved that its allocation between the two was reasonable. 481 F.2d at 1244. Second, the government emphatically states that "the mere fact that a customer-based 'intangible asset' . . . has a 'limited useful life' is not sufficient for amortization under the regulation *or* under *Houston Chronicle* . . . ." (Gov't Br. at 36.) However, if *Houston Chronicle* were construed as the government argues, it would conflict impermissibly with section 167 and regulation 1.167(a)-3. *See Reiter* v. *Sonotone Corp.*, 442 U.S. 330, 341 (1979) ("the language of an opinion is not always to be parsed as though we were dealing with language of a statute"). (*See also supra* at 2-5.)

II.

LEDGER'S SUBSCRIBER RELATIONSHIPS ARE NOT SELF-REGENERATING

Ignoring the record and the undisturbed findings of fact, the government maintains that what is really at issue in this case is not 460,000 *individual* subscriber relationships purchased at a specific point in time, but rather, a "circulation base"—a single asset which, like goodwill, self-regenerates (*i.e.*, as one customer is lost, another customer "appear[s]") and, as such, has an indeterminable life and an immeasurable value. (Gov't Br. at 22-24.) The district court, however, expressly found that Ledger's subscriber relationships are *not* a mass circulation base and are *not* self-regenerating (Pet. App. at 40a), and the Third Circuit did not disturb these findings on appeal. (*Id.* at 14a, 16a.)

While carefully avoiding the label, the government essentially urges this Court to resurrect the long-discredited "mass asset" doctrine—a *per se* rule which presumes that all customer-based assets are self-regenerating and thus, nondepreciable goodwill. (*See id.* at 14a.) Regardless how the government may now articulate its position, application of a *per se* self-regeneration rule to deny depreciation deductions for wasting customer-based intangible assets has been repeatedly rejected because it violates the mandate of section 167 and exalts *per se* rules over proven economic reality:

> Without compiling the myriad cases that discuss the "mass asset" rule, we are satisfied that the rule does not establish a *per se* rule of non-amortizability in every case involving both goodwill and other intangible assets. *** We reject . . . a monolithic "mass asset" theory that would amalgamate all subscription lists with goodwill. *** Our view—that amortizability for tax purposes must turn on factual bases—is more in accord with the realities of modern business . . . .

Houston Chronicle Publishing Co. v. *United States*, 481 F.2d 1240, 1249-50, 1253 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974).[8] Indeed, even the Third Circuit in this case recognized that the mass asset doctrine is "a sort of legal fiction" that is "now outdated." (Pet. App. at 14a.)

A. The Facts In This Case Demonstrate That Ledger Does Not Seek To Depreciate A "Circulation Base"

The facts in this case demonstrate why blind application of the government's mass asset/self-regeneration fiction is no

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8 In fact, the IRS purported to abandon the mass asset rule subsequent to the *Houston Chronicle* holding. Rev. Rul. 74-456, 1974-2 C.B. 65; *see also Citizens & Southern Corp.* v. *Commissioner*, 91 T.C. 463, 482 (1988), *aff'd*, 919 F.2d 1492 (11th Cir. 1990) ("it appears that [the Commissioner] is urging us to apply the 'mass asset' rule although he does not articulate his position as such"; court rejected argument that customer-based intangibles are "as a matter of law the equivalent of goodwill and, therefore, nondepreciable"); *Richard S. Miller & Sons, Inc.* v. *United States*, 537 F.2d 446, 452 (Ct. Cl. 1976) (rejecting the mass asset rule, the court held that "[e]ntitlement to a depreciation allowance is a question of fact and not of law").

longer tolerated and is inappropriate here. The record is clear that, in evaluating the fair market value of the assets of the Booth Newspapers, Ledger valued the 460,000 distinct subscriber relationships in existence at the time it acquired the Booth Newspapers—*not* an amorphous "circulation base." (*See* J.A. at 110, 130-31, 166, 168-69, 170-71.) Indeed, Ledger knew these subscribers' names, addresses and demographic characteristics. (*Id.* at 168-69.) Consequently, Ledger was able to value these specific relationships based on the quantifiable purchases at determinable prices to be made by the subscribers for the predictable future periods the relationships would last. (*Id.* at 53-73.)

In short, there is no evidence to support the government's position that Ledger valued—and now seeks to depreciate—a single mass circulation base that includes subscribers Ledger might acquire in the future, rather than the 460,000 individual subscriber relationships which the seller actually delivered to Herald upon acquisition of the Booth Newspapers. *See Citizens & Southern*, 91 T.C. at 499, *aff'd upon the opinion below*, 919 F.2d 1492 (11th Cir. 1990) ("The new accounts which were opened subsequent to the acquisitions are not in dispute"); *Super Food Services, Inc.* v. *United States*, 416 F.2d 1236, 1239 (7th Cir. 1969) ("Even if we were to find the indivisible [mass] asset doctrine sound in theory, we would have no occasion to apply it to facts such as those presently before us where the taxpayer has made a reasonable showing that the [at-will] contracts were valued individually at the time of the purchase decision."); *Computing & Software, Inc.* v. *Commissioner*, 64 T.C. 223, 236 (1975), *acq.*, 65 T.C. 1153 (1976) (the government's self-regeneration "argument, however, ignores the fact that the issue here deals only with the credit information purchased from [the sellers]. The newly recorded information is not in dispute").[9]

9 The government also suggests that customer-based intangibles, such as those at issue here, are an inextricable component of nondepreciable goodwill, and the "Code and regulations countenance no such 'divide and conquer' approach to goodwill." (Gov't Br. at 23-24.) The government's argument, however, finds no support in the Code, in the Treasury regulations or in the case law. The "analogous" authority cited by the government is plainly inapposite. (*Id.*) The cited cases stand for the proposition that a taxpayer may not transfer to itself a remainder interest in a non-wasting asset (such as land) in order to establish a limited useful life. The consistent rationale for denying depreciation in those cases is that the taxpayer had not acquired anything it had not owned previously and had not incurred additional cost with respect to the retained interest. Accordingly, denying depreciation deductions to these taxpayers correctly implemented the fundamental principles of the Code by: (i) refusing to exalt the asset's form over the substance of the transaction; and (ii) ensuring that the taxpayer, who acquired the "asset" from itself, properly matched expenses with earnings. In contrast, courts have uniformly rejected the government's "bundle of rights" theory where taxpayers have satisfied the factfinder, as Ledger did here, that their customer-based intangible assets, acquired in an arm's length transaction, are truly wasting. *See, e.g., Laird* v. *United States*, 556 F.2d 1224, 1234 (5th Cir. 1977), *cert. denied*, 434 U.S. 1014 (1978); *KFOX, Inc.* v. *United States*, 510 F.2d 1365, 1377-78 (Ct. Cl. 1975); *Meredith Broadcasting Co.* v. *United States*, 405 F.2d 1214, 1225 (Ct. Cl. 1968). (*See generally* Pet. Br. at 33-45.)

B. The Facts In This Case Demonstrate That Ledger's Subscriber Relationships Are Not Self-Regenerating

More importantly, while the government claims that customer self-regeneration is a "standard characteristic" of goodwill (Gov't Br. at 23), there is no evidence to support the government's assertion that Ledger's subscriber relationships are "self-regenerating." Indeed, the district court expressly found that "the paid subscribers of the Booth newspapers as of May 31, 1977, were *not* self-regenerating" (Pet. App. at 40a (emphasis added)) and the overwhelming evidence supported this finding. At the time of the acquisition, Ledger knew that the purchased subscriber relationships would eventually terminate and that it would have to expend substantial efforts and resources to secure new subscribers to replace those that it would inevitably lose. (*See* Pet. App. at 40a; J.A. at 76-78, 112-13, 145-46, 166-67.) In fact, whether Ledger could secure new subscribers was by no means certain because the entire newspaper industry was having considerable difficulty acquiring new subscribers to replace lost ones. (*See* J.A. at 76-78, 139-43, 147, 146-50.)[10] The reasons were numerous and varied,

10 The Report of Urban & Associates, Inc. (Pl. Ex. No. 4, admitted Tr. at 202; 3rd Cir. J.A. at 1115-50) explained the significant difficulty faced by

including competition from other media sources, a worsening economy, and cultural and demographic shifts. (*See* Pet. App. at 40a-41a; Tr. at 205-06, 210, 227-38.) Because the Booth Newspapers are located in Michigan, troubles in the automobile industry would particularly impact Booth's readership. (*See* J.A. at 146.) Moreover, contrary to the government's suggestion (Gov't Br. at 22 n.18), Ledger could not assume that children would automatically replace their parents as subscribers, for newspaper readership among younger generations was on the decline. (*See* Tr. at 228.)

Ledger's proof that it would have to make sizeable efforts to obtain new subscriber relationships as old subscriber relationships ended further demonstrates that the assets are neither *self*-regenerating nor part of Ledger's goodwill. *See, e.g., McCarthy* v. *United States*, 807 F.2d 1306, 1313 (6th Cir. 1986) (intangible assets held not self-regenerating where "the franchise must invest additional capital to retain the asset"); *Super Food Services*, 416 F.2d at 1239 ("When, for example, through the pressure of local competition, ill health, or dissatisfaction with the services provided under the contract, a franchisee terminates his relationship with the taxpayer . . . the value of the purchased business is diminished. Only through taxpayer's own efforts . . . will that value be restored."); *Colorado National Bankshares*, 60 T.C.M. (CCH) at 789 ("petitioner's deposit accounts were not self-regenerating . . . [t]herefore, the deposit accounts were assets with values separate and apart from goodwill").

* * *

newspapers in obtaining new subscribers, and described the declining overall market penetration that newspapers, including the Booth Newspapers, were experiencing. This report demonstrated that not only were all of the Booth Newspapers losing market penetration but also that five of the eight newspapers had suffered absolute declines in the number of their daily subscribers, notwithstanding growth in the number of households in most markets and the substantial marketing and other efforts on the part of the newspapers to obtain new subscribers as the old ones were lost. (*See also* Tr. at 202-13, 227-36, and J.A. 138-51). Moreover, the President of the Booth Newspapers, Werner Veit, testified that the subscriber relationships at issue here are not self-regenerating. (*See* Tr. at 492-97.)

In sum, to apply the government's universally discredited mass asset fiction to Ledger's 460,000 specific subscriber relationships flies in the face of the actual wasting characteristics of these assets—proven at trial, found by the district court and not disturbed by the Third Circuit on appeal.[11]

III.

THE DEPRECIATION OF LEDGER'S ACQUIRED SUBSCRIBER RELATIONSHIPS DOES NOT RESULT IN A DOUBLE DEDUCTION

The government argues that disallowing depreciation deductions for Ledger's wasting assets should be tolerated because taxpayers, like Ledger, are permitted to take annual deductions for current expenses incurred "maintaining and promoting" these same assets. (Gov't Br. at 29-30.) The government's "double deduction" argument is without merit.

Most significantly, the "double deduction" argument rests upon the government's mischaracterization of the assets at issue in this case. Ledger did not depreciate a mass "circulation base"; it depreciated 460,000 specific relationships acquired at a specific point in time. (*See supra* at 11-14.) The fact that extensive promotional efforts had to be undertaken, and expenses incurred, to obtain new subscribers to replace those

11 This case is, therefore, distinguishable from any case where an asset was actually found to self-regenerate. For example, in *Ithaca Industries, Inc.* v. *Commissioner*, 97 T.C. 253 (1991) (cited in Gov't Br. at 23, 42), the Tax Court denied a depreciation deduction for a "work force in place" because the taxpayer had failed to establish *as a matter of fact* that the asset had an ascertainable life and value—not because the asset was *per se* self-regenerating or nondepreciable goodwill. 97 T.C. at 269, 271 ("we conclude from the facts here present that petitioner's assembled work force was not a wasting asset"). In this case, however, Ledger established that its subscriber relationships had determinable lives and ascertainable values and were not self-regenerating. Moreover, the Tax Court in *Ithaca* specifically distinguished this case, and other similar cases involving customer-based assets, on the ground that any new subscriber relationship developed by Ledger is an asset distinct from the previously acquired wasting subscriber relationships. *Id.* at 268, 270.

which were lost confirms that the 460,000 purchased subscriber relationships were *not* self-regenerating. *(See supra* at 13-14.) In short, the two deductions to which the government refers apply to completely *different* assets.

The depreciation deduction reflects the annual diminution in the value of the 460,000 *purchased* subscriber relationships. The annual current expense deduction applies to expenses, such as subscription drives, incurred to acquire *new* subscriber relationships. Indeed, the same analysis would apply if the purchased subscriber relationships were embodied in fixed-term contracts. The government concedes that such assets would be depreciable. If Ledger had to expend additional resources to obtain new fixed-term subscribers as the old fixed-term contracts terminated, these costs would be separately accounted for, whether capitalized or expensed, based on the particular facts presented. *See INDOPCO, Inc.* v. *Commissioner*, 112 S. Ct. 1039 (1992). In this case, such costs are indisputably deductible as current expenses pursuant to the express congressional mandate of section 173 of the Internal Revenue Code.[12]

Not even the deduction for costs incurred to maintain the *original* 460,000 subscriber relationships results in a double deduction. Ledger's deductions to maintain its existing subscriber relationships are no different from the deductions taken by taxpayers to maintain indisputably depreciable tangible assets. (*See* Pet. App. at 41a.) For example, a machine that has a useful life of ten years is without question depreciable over a ten-year period pursuant to section 167. However, without proper maintenance, the machine's useful life might be significantly diminished. Accordingly, in *addition* to the depreciation deduction under section 167, Congress has also provided a current deduction for costs incurred to maintain depreciable assets, for only by expending these maintenance costs will the asset achieve its true useful life. *See* Treasury Regulation 1.162-4.[13]

12 In fact, not only is there no double deduction in this case, but the government actually enjoys an advantage in the collection of taxable income. This is because there is a lack of symmetry in the timing of the tax treatment between the seller and the purchaser of a business which favors the government—not the taxpayers. The Booth Newspapers' seller was subject to tax on the full amount of the gain in the year of sale. However, Ledger, the purchaser, is required to deduct the cost of its expenditure over the assets' useful lives—in some cases more than 20 years.

Finally, the government suggests that the administrative difficulty in allocating "ordinary business expenses" to generate new customers (*e.g.*, advertising expenses) between the "current" expense component—which aids the production of income only within the current taxable year—and the "capital" expense component—which aids the production of income for more than one year—somehow justifies denying the depreciation of Ledger's subscriber relationships. (Gov't Br. at 30-31.) Without citing any authority, the government contends that the IRS has "adopted" a solution to this allocation problem pursuant to which taxpayers are allowed a current expense deduction for all expenses to generate new customers (customers the government characterizes as "goodwill") and denied depreciation deductions for "goodwill." (*Id.* at 32.) By making this trade-off, the government asserts, an equitable matching of income and expenses is achieved. (*Id.*)

13 The government posits that, if Ledger's subscriber relationships were deemed depreciable intangible assets under section 167, then they would also be subject to a loss deduction under section 165 of the Code. (Gov't Br. at 29 n.25.) This, the government argues, would be "absurd" because, unlike an irreparable machine which requires the taxpayer to incur costs to acquire a new machine, the loss of one subscriber relationship is automatically accompanied by the gain of another subscriber relationship. (*Id.*) The government's attempt to accord disparate tax treatment to intangible and tangible assets directly conflicts with its own admission that *both* types of assets are subject to depreciation deductions under section 167. (*Id.* at 12.) Ledger's subscriber relationships, like a machine, do *not* self-regenerate. (*See supra* at 12-13.) Accordingly, in order to achieve proper matching, if Ledger's wasting subscriber relationships unexpectably terminate—for example, an explosion kills all of the subscribers to the newspaper—then the loss of those relationships is, in fact, deductible under section 165 because Ledger will have to incur substantial expense to obtain new subscribers. *See* Rev. Rul. 71-418, 1971-2 C.B. 125 (accountant who purchased a single client account and capitalized the cost of the account was also entitled to a loss deduction under section 165 when the client died).

This argument is utterly unfounded and has no relevance to this case. The argument is unfounded because, as the government concedes, depreciation deductions are not permitted for goodwill because it is an asset that has no determinable life. (*Id.* at 13-16.) In any event, Ledger has never argued that it is entitled to depreciate "goodwill" and, at the same time, currently deduct expenses to build "goodwill." At issue *in this case* are the " '*old*' subscriber relationships that [Ledger] purchased from Booth." (Gov't Br. at 30 n.26) (emphasis added). As the government concedes, Ledger was *not* entitled to take a current expense deduction for these assets in the year that they were purchased (*id.*), and Ledger did not do so. Accordingly, to also deny Ledger a depreciation deduction for these wasting assets would clearly distort Ledger's annual matching of earnings and expenses.

The argument is irrelevant because the *new* subscribers Ledger may have obtained subsequent to the acquisition of the Booth Newspapers—and the expenses incurred to obtain them—are *not* at issue here. (*See* Pet. App. at 40a.) Nevertheless, even if some of Ledger's expenses to secure *new* subscriber relationships aid the production of income for more than one year, Congress has expressly allowed taxpayers in the publication industry, like Ledger, to take a current expense deduction for these expenses. 26 U.S.C. § 173. Ledger does *not*, however, receive an additional depreciation deduction for the assets secured by these expenses. Accordingly, unless Congress amends section 173 of the Code, neither the Court nor the IRS may compel Ledger to capitalize any expenses to obtain new subscriber relationships. *See Hanover Bank* v. *Commissioner*, 369 U.S. 672, 688 (1962) ("the Government now urges this Court to do what the legislative branch of the Government failed to do or elected not to do. This, of course, is not within our province"); *International Trading Co.* v. *Commissioner*, 484 F.2d 707, 711 (7th Cir. 1973) ("Our task is to construe and apply, not to write, legislation").

CONCLUSION

The government concedes that, in order to achieve the proper matching of income and expenses in a particular taxable period, all wasting assets *shall* be depreciable and that goodwill is not depreciable only because it is an asset which does not waste. Ledger's assets, unlike goodwill, were proven and found to waste and not to self-regenerate—findings not disturbed by the Third Circuit on appeal. The government's position in this case, therefore, is directly at odds with its own concessions and the plain words of section 167 of the Internal Revenue Code. Accordingly, in order to apply the congressional mandate of section 167, this Court should reverse the judgment below—denying Ledger a depreciation deduction for its wasting assets—and give effect to the fundamental precept of the federal revenue laws that income tax is a tax on net—not gross—income.

Respectfully submitted,

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